Report by the
Comptroller and Auditor General

Department of Trade and Industry

The Acquisition of German Parcel

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Executive summary

1 The Post Office is a state owned business accountable to the Secretary of State for Trade and Industry. It has a statutory monopoly in the delivery of letters and parcels costing less than £1 in the United Kingdom (unless they weigh over 350 grammes) but operates in competition with other businesses for all other mail. The Government announced significant changes in the operating framework for the Post Office in the White Paper "Post Office Reform: A World Class Service for the 21st Century" published in July 1999. This set out plans for:

i) greater competition in the postal market;

ii) giving the Post Office greater freedom to operate commercially so that it can be managed more efficiently and compete more effectively in an increasingly liberalised and competitive international market; and

iii) the creation of a new, transparent and accountable regulatory framework.

2 The Post Office's aim, approved by the Government, is to transform itself into a leading international business supplying customers with a full range of global distribution services. A key element in the strategy to achieve this is a programme of acquisitions:

i) to help the competitiveness of the core business by allowing the Post Office to offer a seamless letters and parcels service, based on high quality networks over which it has direct control, to its large business customers (who represent about a quarter of its turnover); and

ii) to secure a position in key international markets, on which it can then build, while opportunities are still available.

3 In January 1999, in line with policy announced in December 1998 and set out in detail in the White Paper, the Post Office acquired German Parcel, the third largest private parcel business in Germany, for £289 million (see Figure 1). The Post Office also spent £10 million on advisers' fees in connection with the acquisition. This was its first major diversification into overseas markets and was undertaken in agreement with the Department of Trade and Industry (the Department) and Treasury.

4 This report is about the oversight by the Department of this acquisition. The National Audit Office is specifically barred by the National Audit Act 1983 from carrying out the audit of the Post Office. We are, however, the auditors of the Department whose agreement was needed for the acquisition to go ahead. The report takes as given, as a matter of policy, the overall business strategy leading to the acquisition, approved by Ministers. In view of the importance of the acquisition, and the complexity of the situation in that the Department had the responsibility to agree the acquisition but not to carry it out, we decided to examine:

i) the Department's responsibilities and role relating to the acquisition;

ii) how the Department sought to protect the interests of the taxpayer; and

iii) what lessons of good practice can be established for sponsor departments that have oversight of future acquisitions by state owned businesses.

Findings

The Department has a responsibility to scrutinise large acquisitions carefully

5 The proposed reforms of the relationship between the Post Office and the Department allow the Post Office the freedom to acquire other businesses and build its position as a major global distribution company. This freedom is subject to the Department's requirement that it should have oversight of any acquisitions that exceed £75 million (raised from £20 million as part of the reforms). The rationale for such a threshold is that large transactions, even in the ordinary course of business, can be so significant that they merit scrutiny by the owner. We consider that large acquisitions in overseas markets or new product areas are a diversification of the business and merit additional attention from a sponsoring department because they represent an increased risk to the taxpayer's interests **(paragraph 1.13)**.

6 A full assessment of the value for money of the acquisition, taking strategic benefits into account, will not be possible in isolation from the Post Office's overall strategy and programme of acquisitions, which will not come to fruition for a number of years **(paragraph 2.17)**.

The Department appointed an adviser to examine the Post Office's appraisal carefully

7 The Department agreed that the Post Office could go ahead with the acquisition on the basis that:

- it fitted with the strategy for the Post Office approved by Ministers; and
- the Department's analysis of the Post Office's appraisal showed that German Parcel as a stand-alone business, that is without taking into account any potential synergies with the Post Office's other businesses, and after taking into account purchase costs, would not lose money **(paragraph 2.6)**.

8 In our opinion, the Department's approach of assessing the acquisition on a stand-alone basis was reasonable given the difficulties in valuing strategic benefits and uncertainty over the extent to which they might be achieved. The Department was keen not to duplicate work and relied on the Post Office and its advisers to carry out a valuation of German Parcel, to establish the potential risks and liabilities that the acquisition would entail and to negotiate with the vendors. The Department's confidence in the Post Office's judgement derives partly from its historical "arm's length" relationship with the Post Office, which meant that it was usual for the Department to assure itself that the Post Office was taking appropriate advice and approaching a transaction in a sensible way, rather than becoming closely involved in the appraisal. In addition, the Department considered that the Post Office had developed experience in appraising acquisitions, including taking appropriate advice **(paragraphs 2.8, 2.9, 2.11, 2.13 and 2.17)**.

9 The Department's team responsible for advising on the acquisition recognised that it did not have sufficient expertise to assess the proposed acquisition and therefore employed an individual adviser who had senior level commercial banking experience of appraising the risks of major investment proposals by client companies and had been a member of the Department's Industrial Development Advisory Board. When making the appointment in November 1998, the Department sought to satisfy itself that the Post Office had gone through an appropriate process in pursuit of this acquisition. The adviser was not required to carry out a full critique of the valuation exercise undertaken by the Post Office but rather to look at the way in which it was managing its processes and to test some of the key assumptions. In doing so the adviser was required to work to a tight, commercially driven timetable as is usual in an acquisition **(paragraph 2.9)**.

10 German Parcel was a difficult business to assess. It had few assets although it owned the computer software that allowed it to track a package at any stage in a journey which gave the business its main competitive strength. It belonged to 24 franchisees and its managing director, and provided its franchisees with central distribution facilities and administrative and logistical support. The majority of the franchisees also owned road haulage and other distribution businesses, which in some cases were partially dependent on, and integrated with, the parcels franchise business. Central accounts for the whole business, including the franchisees' depot operations, did not exist. Moreover audited accounts for individual depot operations did not, in many cases, exist. The Post Office had to buy out the relevant part of the franchisees' other businesses and enter into two year contracts with them to carry on giving German Parcel the parcels business that they had been routing through it. German Parcel also had a valuable investment in a Europe-wide franchise network (General Parcel), set up on the German Parcel model, which had the potential to offer strategic benefits to a purchaser above the value of German Parcel's 24 per cent shareholding in it **(paragraphs 1.20 to 1.24)**.

11 The Post Office and its advisers, PricewaterhouseCoopers, primarily relied on a model of the business's projected cashflows to develop a valuation. The operating profit assumptions in the model drove the valuation. The lack of central accounts for the whole business, together with the tight timescale that the Post Office was operating to, meant these assumptions were based on 1997 unaudited operating results, as estimated by German Parcel management. Individual profit margins were not taken into account in the price paid to individual franchisees because the Post Office had decided against negotiating special deals with individual vendors. This was the vendors' preference and the Post Office perceived the risk of losing the deal by attempting individual negotiations to be very high. The Post Office, therefore, only had relative certainty on the operating profit made by the central business itself. This accounted for 18.5 per cent of the total operating profit assumed in 1997, the base year for the projections of the value of the business. The Post Office provided for the purchase price to be adjusted after the acquisition to reflect the actual turnover in 1998. The risk of inaccuracies was partly mitigated by a warranty from the franchisees, providing a possible clawback of about 28 per cent of any excess price paid as a result of the assumed operating profit being too high. The effectiveness of this and other contract remedies was underpinned by agreement to pay the purchase price in stages **(paragraphs 2.11, 2.12, 2.14 and 2.16)**.

12 The Department recognised that there was uncertainty attached to its conclusion that, on a stand-alone basis, the acquisition would not be worth less than the purchase price. This is demonstrated by the wide range of the Post Office's financial projections of the value of the business, based on discounting operating profits in perpetuity. The Department and its adviser concentrated their evaluation on the base case and, taking the purchase price into account, the loss making worst case. We have agreed, on grounds of commercial confidentiality, not to publish details of the cases examined. The range from best to worst of about £109 million in 1999 values indicates, however, the degree of uncertainty. The Department was satisfied that the Post Office had identified the key risks to the acquisition and was taking appropriate steps to manage those risks to make a success of the venture and avoid losses. The Department also expected, however, that there would be synergies with the Post Office's other businesses which would lead to financial benefits. The Post Office had quantified some of these benefits - estimating, for example, that the acquisition could protect income that would otherwise be lost in its Parcelforce business in excess of Parcelforce's 1998-99 losses (£25 million). In the limited time available for reviewing the robustness of the business case, the Department's adviser had met the Post Office, questioned the growth rate assumptions and the risks to profitability, such as the possibility that costs in the different franchises might harmonise at a higher level, and formed the overall view that the price proposed was reasonable **(paragraphs 2.12, 2.15 and 2.18)**.

13 If time and access to individual franchise businesses had allowed, it is arguable that a more extensive appraisal of the Post Office's business case and valuation might have reduced the uncertainty attaching to the Post Office's conclusion. But such an appraisal might not have been practical in the circumstances and the Department in any case covered the ground (see Figure 10). The Department also considered that the implementation of the Post Office international strategy, of which this was the first significant step, was essential to the repositioning of the Post Office in the global distribution market. Building on the experience it gained from this transaction, we note that the Department has retained Deloitte & Touche to lead and co-ordinate a multidisciplinary team to comment, as and when required, on the Post Office's proposed strategy and on the range of issues that might arise following any further major acquisition proposal from the Post Office **(paragraphs 2.18 and 3.7)**.

The funding of the transaction is at commercial rates of interest

14 The Department and Treasury agreed that some £80 million of the cost of the transaction could be funded by borrowing in Germany by the Post Office on commercial markets. Unusually for the public sector, the Department proposed that the remainder (up to £238 million to cover the costs of working capital, some property assets, and advisers, as well as the remainder of the base price, Figure 11) should be met from public sector borrowing at commercial rates of interest. This was in part to assure competitors that the Post Office was not acting in an anti-competitive way and also because the Department wanted the Post Office to be subject to commercial disciplines as well as having greater commercial freedom. We note that adopting this method of funding can only act as a commercial discipline on the Post Office if, when the accounting treatment is settled, the Department can see the impact of the higher rate on the financial performance of German Parcel. This could be done in a number of ways depending on the overall reporting structure for the Post Office's European network, currently under discussion with Deloitte & Touche (**paragraphs 2.21, 2.33 to 2.34 and 2.42)**.

15 The Department had not set a rate of interest on the borrowing by mid July 2000 although at the time of the acquisition the Post Office was aware of the maximum rate that was likely to be agreed. The delay in reaching agreement was partly caused by the necessity to undertake wide consultation on the proposed policy of charging a commercial interest rate to bodies in the public sector. The rate will be set following advice from Deloitte & Touche on what the Post Office's credit rating might be if it was a company in the private sector. A credit rating is an assessment of a company's ability to meet its debt service obligations. The exercise was carried out to determine the interest rate that the Post Office would be charged to borrow in the market, on the basis that it did not have an implicit or explicit Government guarantee, nor access to the large cash reserves built up over the years from its monopoly business. As this will be the first time that a public body will be borrowing from the National Loans Fund at a commercial rate of interest, new guidance and procedures are being introduced by the Department to effect this change. The Department told us that the resulting commercial cost of credit will be charged retrospectively and in full once arrangements are in place **(paragraphs 2.36, 2.37, 2.39 and 2.40)**.

Concerns about possible unfair competition have been assuaged

16 The Department confirmed that (as required by legislation) the Post Office obtained clearance from the relevant competition authority - the German Federal Cartel Office, after the European Commission confirmed that it did not have jurisdiction. A number of competitors of the Post Office nevertheless expressed concern to us that the Post Office might have used reserves built from profits earned on its monopoly activities to fund the acquisition or that it had access to borrowing at low rates, giving it an unfair advantage over other businesses in the industry. Their concerns were enhanced because the Post Office did not announce the price it had paid at the time it announced the acquisition. The competitors that we spoke to have confirmed to us that some of their concerns about unfair competition have been assuaged by the agreement that acquisitions should be funded entirely by borrowing at a commercial rate. One competitor, TNT Post Group, called for acquisitions to be evaluated and monitored on the basis of a discount rate that reflects the overall cost of capital. This is how TNT Post Group evaluates and monitors the acquisitions that it makes. The Department expects the Post Office to do this **(paragraphs 2.23, 2.43 and 2.44)**.

The Post Office's performance targets were not adjusted to take account of the acquisition

17 In common with most public sector businesses, the Post Office is set financial targets by the Government. The principal financial targets for the Post Office in 1998-99 were an External Financing Limit of £310 million and a Return on Capital Employed of 20.0 per cent for Royal Mail and 5.5 per cent for Parcelforce. The External Financing Limit was the sum of cash that the Post Office agreed to pay over to the Government from its profits. The Department did not adjust the Post Office's financial targets following the acquisition because arrangements relating to the External Financing Limit were under review as part of the Post Office reforms and because the Return on Capital Employed for the acquisition was forecast to be within one per cent in four out of the next five years. It should be noted, however, that the Department, with advice from Treasury, required that the performance of German Parcel be monitored against the target Earnings Before Interest and Tax in the business plan. The Department also made it a condition of approving the funding, that a percentage of the bonus of the Chief Executive of the Post Office (half of a possible 10 per cent personal bonus) should be linked to how well the acquisition performed against this target measured in Deutschmarks. The Post Office provided its first annual report on the performance of the acquisition to the Department in April 2000 to provide a basis for monitoring this condition. Future monitoring arrangements are currently under review with Deloitte & Touche **(paragraph 2.21)**.

We have identified a number of lessons of good practice

18 While the Department took its responsibilities seriously, this was one of the first major acquisitions by a public sector body and there was little experience to draw on. In addition to benefiting from the Department's own experience we, therefore, broadened our analysis to include good practice in the handling of acquisitions by private sector companies, including the requirements that the London Stock Exchange imposes on companies listed on it. We consider Stock Exchange procedure should be taken into consideration when determining the level of disclosure of information by public sector corporations. It will be less relevant to departments' approval of a transaction because departments will generally have set individual materiality thresholds based on considerations particular to the individual company. In the case of the Post Office, the Department has set a threshold of £75 million per year. Sponsoring departments faced with transactions above the relevant threshold for review may wish to consider carefully the benefits of adopting the following practice:

i) **Obtaining assurance from the whole Board of Directors on their detailed knowledge, approval and accountability for the acquisition, together with opinions from relevant external advisers giving assurance on the terms agreed.** This suggestion is compatible with practice in the private sector in that companies quoted on the London Stock Exchange, subject to a materiality test, are required to send shareholders a declaration covering, for example, the completeness of the information sent to them, and a voting recommendation that the acquisition "is, in the opinion of the directors, in the best interests of the shareholders as a whole". It is also usual practice for the directors of quoted companies to ask for opinions from their professional advisers about the implications of a transaction, which they rely on when advising shareholders **(paragraph 3.4)**.

   In the case of the acquisition of German Parcel the Chief Executive of the Post Office wrote to the Department reporting unanimous Board approval to the acquisition. The Department saw the documents the Board received and told us that they were not very detailed. We consider that the level of detail provided to the Board is highly relevant as the Board itself is likely to be the best judge of the implications of the transaction for the business **(paragraph 3.3).**

ii) **Putting together a team with corporate finance experience and industrial sector knowledge, supported by external advisers, to appraise a proposal.** This is standard practice in privatisations although a smaller team is likely to be needed in the case of an acquisition. The Department's current arrangements with Deloitte & Touche allow it to access a wide range of skills. We note that in some countries the practice is for oversight of nationalised industries to be carried out by a single department. This has a number of advantages and disadvantages and in the case of the oversight of transactions such as acquisitions may allow a greater depth and breadth of commercial expertise to be brought to bear; as broadly speaking the establishment of Partnerships UK has allowed a wide range of skills and depth of experience to be brought together to advise on the development of privately financed projects, including the most appropriate advisory team to be used on a transaction **(paragraphs 3.7 and 3.8)**.

iii) **Asking for the disclosure of analogous information to that which would have been required had the state owned business been quoted on the London Stock Exchange. This would, where relevant and material, include information on the price paid, the profits attributable to the net assets being bought, and the effect of the transaction on the profit and loss account and balance sheet of the purchaser (see Figure 13)**. These requirements were developed for investor protection and to allow the market to appraise the prospects of a company adequately. A number of private sector competitors of the Post Office have to meet these requirements and the Government and the Post Office are keen for it to be treated more like a private sector company. The Post Office initially only disclosed a broad indication of the value of the transaction. The Department has told us that it accepts our argument that there is a case for the Post Office and other similar public bodies to accept analogous rules. This should also help assuage competitors' fears that a business is acting uncompetitively **(paragraph 3.12)**.

iv) **Agreeing a clear statement of performance targets, such as a stated contribution to profits, before agreeing to an acquisition**. This can act as a useful discipline on purchasers who, in pursuit of corporate growth, may be less demanding of the performance of an acquisition than the shareholders, whose concentration in the private sector is on earnings per share. This was partly carried out in the German Parcel case by setting short term stand-alone targets based on German Parcel's Earnings Before Interest and Tax for the next two to four years, and the Department did link the Chief Executive of the Post Office's bonus to the financial performance of the acquisition. We see advantages in similar practice of overall performance targets being followed in the public sector to bring greater emphasis on value for money **(paragraphs 3.16 and 3.17).**